The Firm

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What does change in IHT legislation mean for wealthy couples?

Death and taxes are the certainties of life, and it can be a bitter financial pill to swallow on top of the emotional trauma when both occur at once. Following the recent change in Inheritance Tax thresholds. Following the recent change in Inheritance Tax thresholds, Karen Reid sheds some light to help you navigate the confusing path ahead.

The value of an estate that can pass tax free to family heirs on the death of a surviving parent has doubled to £624,000 following a change in Inheritance Tax legislation that allows any unused part of the nil rate threshold from the first death to transfer to the survivor. This change means that up to £125,000 of tax could potentially be saved at current rates.

But whilst the introduction of the transferable nil rate band is welcome, it should not be relied upon solely if couples have combines taxable estates in excess of twice the IHT threshold where they have substantial liquid capital which they wish to grow in value.

Although the new rule has been introduced by the government to counter opposition proposals to raise the threshold for Inheritance Tax to £1 million, much the same effect could have been achieved using a nil rate band will trust whereby, rather than the entire estate passing to the surviving spouse, any amount up to the nil rate threshold would have been diverted into a family trust on first death.

This was achieved by an amendment to the wills with mirror provisions for each spouse to give the same effect whichever partner died first. Since the survivor might still require some of the money, the trust would typically allow trustees to lend money back to the survivor as and when necessary to meet his or her financial needs. This had the added advantage of building up a debt against the survivor's own estate to further reduce the value potentially liable for Inheritance Tax on the second death.

These remain practical reasons why the nil rate band will trust could potentially be of greater benefit that the transferable nil rate band, for example, where heirs include children from a previous marriage. In such circumstances rather than the survivor having complete control over the distribution of the combined estate, potentially to the detriment of their deceased spouse's family., some or all of the capital would instead pass into a trust specifically for the benefit of the deceased's family.

This form of will planning was relatively easy to achieve where the estate included a sufficient element of free or realisable capital. If the estate was mostly in the form of heritable property, them more complex arrangement were needed, but the same result could still be achieved. The objective in all cases was to make use of both spouse's nil rate bands, rather than just that of the surviving spouse.

One advantage of the new legislation is that it may be simpler where the family home comprises the vast majority of the estate. But in those cases where there are liquid assets too, such as investment or cash, relying too heavily on the transferable nil rate band could be a mistake.

A flattening property market will ease the pressure on the government to raise the Inheritance Tax threshold on the back of rises in house process and, for that reason alone, Inheritance Tax will probably rise at a lower rate than it has done over recent years. This means that leaving everything to the survivor on first death, rather than extracting some capital at that time, could give rise to unnecessary tax on the second death, rather than extracting some capital at the times, could giver rise to unnecessary tax on the second death if the value of the transferred estate increases by more than the rise in the threshold. Whilst it is clearly desirable that any invested capital should continue to grow in value, any net gain above the rise in threshold would potentially suffer Inheritance Tax at 40% on the second death. A solution to this would be for the survivor to set up a loan trust for that part of the estate that is in liquid form or readily realisable. The taxable value of the capital is then fixed in time, with any growth residing out with the survivor's estate for tax purposes and retained in the trust for the beneficiaries.

To achieve this the capital is placed in trust as an interest free loan rather than an outright gift. The principal remains in the ownership of the individual and the loan is repayable on demand giving access to part or all of the capital, should it be needed, Usually theses arrangement are documented to have annual loan repayments, which the investor uses to supplement his or her income. And if set up correctly, the draw down is tax free.

Karen Reid is Associate Director of Glasgow-based estate planning and portfolio management company CFG Wealth Management.